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ABSTRACT

Endowment practices at 23 institutions during 1978-1983 were studied to provide recommendations on endowment fund management for colleges and universities. Although most of the participating colleges were privately supported, two state-supported universities were included. Twelve of the institutions used a systematic approach to improving endowment management, while 11 used a more traditional and less intensive approach. It was found that institutions employing independent consultants, multiple investment managers, and a systematic approach to policies and endowment management practices performed significantly better than institutions that took other approaches to endowment management. Study findings suggest that important factors in improving performance are appropriate trustee interest and involvement, institutions' retaining external professional managers of endowment investments, and using independent consultants to evaluate managers and performance. Appendices include: a set of questions trustees might consider as they manage their endowment funds; a sample statement for colleges and universities regarding investment policy, objectives, and guidelines for endowment funds; and a sample spending guideline statement and a spending plan illustration. (SW)

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Improving Endowment Management

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Improving Endowment Management

Prepared By
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in cooperation with
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The National Association of College and University Business Officers

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Foreword

In 1982 the Academy for Educational Development (AED), along with the Association of Governing Boards of Universities and Colleges (AGB), the American Council on Education (ACE), The Common Fund, and the National Association of College and University Business Officers (NACUBO), received funding to study endowment practices at 23 sample institutions. The purpose of the study was to provide recommendations for colleges and universities on the best way to manage endowments.

Endowment management is a critical area of responsibility for everyone in higher education involved in both administration and policy making. Yet it often receives less attention than it should, especially considering that the impact of endowment management goes well beyond the amount of the endowment itself. Strong endowments and solid endowment management procedures have a positive impact on an institution's marketing, its enrollment, and even its ability to receive major research contracts.

The 23 institutions chosen for the study, listed in the Introduction, are a cross section of the various types and sizes of all endowed colleges and universities in the United States. However, the study team was able to draw conclusions about endowment management that apply generally to the special needs of higher education. The study team has prepared sample questions and paradigms that can guide an individual institution toward an endowment management plan tailored to its individual situation.

The organizations conducting this study represent the key constituents responsible for setting policy and administrative controls over endowment funds. AGB and the other associations involved in this project believe that we all have an obligation to bring this report on endowment management to the attention of the key players facing this important and challenging problem.

The Richard King Mellon Foundation, the International Business Machines Corporation, and the BankAmerica Foundation supplied funds for preparing and printing this report and for disseminating it to key constituents; they recognize the important role successful endowment management plays for individual institutions and in higher education as a whole. We are grateful to George H. Taber, vice president and director of the Richard King Mellon Foundation; Charles R. Bowen, director of plans and program administration, university relations, of the International Business Machines Corporation; and Edward Truschke, president of BankAmerica Foundation, and his colleague Caroline Boitano, program officer of the foundation, for their understanding of the importance of this issue. We appreciate their support of the study and their dedication to higher education.

ROBERT L. GALE
President
Association of Governing Boards of Universities and Colleges

Preface

This study of the endowment management practices at 23 colleges and universities clearly indicates that those institutions employing independent consultants, multiple investment managers, and a systematic approach to policies and endowment management practices perform significantly better than institutions that take other approaches to endowment management.

The data and information collected during the study strongly suggest that important factors in improving performance are appropriate trustee interest and involvement, institutions' retaining external professional managers of endowment investments, and using independent consultants to evaluate managers and performance.

Trustees have a unique and critical role in assuring that the endowment funds of a college or university are properly managed in support of the objectives of the institution. The evidence is compelling that diligent attention to managing the endowment can produce significant benefits. Appendix A to this report presents a set of questions trustees might want to ask as they seek to ensure that the institutions for which they have fiduciary responsibility are managing their endowment funds appropriately.

Obviously, the needs of each institution will vary as will the expertise and interest of trustees in managing the endowment. Most institutions would be well served, however, by retaining independent consultants to review their endowment policies and performance and to advise the appropriate trustee committee on the actions that might be required. The cost of the review would be insigificant when compared with the long-term costs associated with poor endowment management decisions.

Another alternative available to education institutions is to participate in The Common Fund, a pooled endowment investment program that employs multiple investment managers and utilizes a number of independent consultants to an extent that is beyond the capabilities of all but the largest endowments.

In selecting independent consultants, every institution should make sure that the person or firm chosen is familiar with the very special requirements of higher education, and should require a written statement providing assurance that the independent consultants will not receive fees or compensation from any source other than the institution served or at its specific direction. Requiring such a statement will avoid potential conflicts of interest.

Endowment funds are vital to independent and public institutions. During the 15 years since the 1969 Ford Foundation study, "Managing Educational Endowments," the management of endowments has improved considerably. Today, much more information is available to trustees on what constitutes good endowment practice and performance.

Appendix B to this report provides a sample statement for colleges and universities regarding investment policy, objectives, and guidelines for endowment funds. Appendix C provides a sample spending guideline statement and a spending plan illustration.

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Introduction

This study came about as a result of concerns expressed about the management of their endowment funds by a number of college presidents involved in a Kellogg Foundation-sponsored analysis of institutional planning.

The presidents' comments concentrated primarily on their being unsure of what was expected with regard to the rate of return on their institutions' endowment funds; the respective responsibility for operating the endowment funds by the administration, the trustees, and the external managers or advisers; and the most effective process for ensuring that the management of the endowment would meet the expectations of donors as well as the objectives of each institution.

With these concerns in mind, the Academy for Educational Development undertook a study of the endowment management practices for the five years between July 1, 1978, and June 30, 1983, and the results of these practices at 23 colleges and universities. The study was conducted in association with the American Council on Education, the National Association of College and University Business Officers, Investment Management Control Systems, a division of Janney Montgomery Scott Inc., and The Common Fund. The goal of the study was to arrive at conclusions and recommendations about endowment fund management that could be used by all education institutions with substantial investment funds.

The 23 institutions studied were:

Berea College
Bowdoin College
Carnegie-Mellon University
Colby College
Davidson College
DePauw University
Dillard University
Lehigh University
Loyola University (Chicago)
Mills College
Occidental College
Pomona College
Randolph-Macon College
Rochester Institute of Technology
St. Louis University
Smith College
Southern Methodist University
Trinity College (Connecticut)
University of Cincinnati
University of Michigan
University of Richmond
Vassar College
Wesleyan University

For analysis purposes the institutions studied were divided into two groups: Group A consisted of 12 colleges and universities, each of which had completed a major review of endowment management before the study was undertaken. In each instance the institution had employed independent consultants to help evaluate investment management policy and performance. Most had restructured endowment management in an effort to improve results and had used independent consultants to assist in screening and selecting managers.

Although the study team did not know in advance of compiling the data exactly how the investment results of Group A institutions would measure up, there was no doubt that the endowment funds of these institutions were among the best managed in the country. All but one of the Group A institutions used multiple investment managers in order to diversify the handling of various portions of the endowment portfolio.

Group B consisted of 11 institutions that at the beginning of the study had not gone through an intense, formal review of endowment management and had not used independent consultants. Here also, the comparative performance of the institutions in this group was not known in advance of compiling the data. The study team felt that institutions in Group B were representative of the endowment funds that have not made a concerted or special effort to improve investment management. Most Group B institutions had used a single manager, usually a local bank or an investment management firm chosen by the institution's board of trustees, and had not used professional consultants.

On June 30, 1983 (the ending point of the study), endowment investments of Group A institutions amounted to $1.2 billion; the total for Group B institutions was $840 million.

The combined endowment investment total for both groups, just over $2 billion, was equal to approximately 7 percent of the $30 billion total value of the endowment funds held by all colleges and universities in the country. Although this is a small percentage, and the 23 institutions were not statistically representative of all colleges and universities in the country with endowments, the study team felt the sample was large enough to warrant making generalized conclusions about the management of endowment funds held by education institutions.

Most of the participating institutions are privately supported. Two state-supported universities were included, however, because of (a) the growing importance of fund raising and endowment management in public institutions and (b) their interest in being involved in the study.

During the course of the study, members of the study team visited the campus of each institution, sometimes more than once. They met with administration officials concerned with endowment management, collected financial information, visited with investment managers where appropriate, and prepared extensive analyses. Some of the information collected was quantitative and concerned operating performance and allocating the assets in endowment funds. Other information concerned the endowment management process at the institution, the role of investment managers and external advisers, the use of endowment resources, and the level and form of trustee participation in endowment management. There was clear evidence that many trustees were aware of the issues in endowment management but were not sensitive either to the complexities of the issues or the sources and uses of data.

Major Findings and Conclusions

A systematic approach to investment management and sharply focused trustee involvement in the investment process result in improved performance.

Those institutions using a systematic approach to improving the management of their endowment resources (Group A) significantly outperformed the institutions that use a more traditional and less intensive approach to endowment management (Group B). The results were achieved not only for the entire five years covered by the study but also were especially dramatic during fiscal year 1983, a strong year in both the bond and stock markets.

Table I compares the five-year annualized total rate of return for the two groups in the study. The table also includes the annualized return information for the 220 funds reporting to the National Association of College and University Business Officers (NACUBO).

TABLE I

Comparative Rate of Return on Endowment Investments
Fiscal Years 1978–79 to 1982–83

Item	Five-Year Annualized Rate of Return	Rate of Return Fiscal Year 1983
Group A Institutions*	15.6%	48.1%
Group B Institutions*	13.8%	37.5%
Difference between Group A and Group B	1.8%	10.6%
NACUBO Funds	14.8%	41.3%

*The annualized returns for Group A and B institutions were calculated as a dollar-weighted average of the total annual returns for the institutions in each group.

The differences in the rates of return reflect *both* the decisions on the allocation of assets among different types of investments and the performance of the investment managers.

Table II shows the five-year annualized rate of return for each of the 23 institutions, arrayed in descending order.

TABLE II

Comparison of Return on Endowment at 23 Colleges and Universities
Fiscal Years 1979 to 1983

(Dollar figures are in thousands)

Institution	Average Endowment Value-Fiscal 1979–1983	Actual 5-Year Annualized Rate of Return	Ending Value of Endowment 6/30/83
#1	$132,402	14.9%	$173,434
#2	128,408	17.1%	162,774
#3	127,316	16.1%	178,483
#4	116,126	12.3%	153,115
#5	113,679	12.1%	126,614
#6	108,679	17.1%	148,647
#7	107,155	13.8%	148,765
#8	74,029	14.6%	111,433
#9	72,710	18.4%	126,781
#10	71,827	14.7%	100,638
#11	70,193	17.9%	110,143
#12	61,774	12.5%	81,030
#13	55,547	12.5%	80,463
#14	52,908	15.6%	71,000
#15	41,625	12.5%	51,253
#16	39,700	12.2%	52,000
#17	31,951	17.9%	47,332
#18	25,685	13.7%	29,092
#19	25,355	15.9%	41,743
#20	22,790	14.6%	31,575
#21	22,342	12.9%	32,195
#22	8,612	14.9%	11,237
#23	5,352	15.7%	6,785

NOTE: The Market Index return was obtained by calculating the return that each college would have had if the amount which it had allocated each year to stocks had earned the return on the Standard & Poor's Stock Index, the amount invested in bonds earned the return on the Salomon long term corporate bond index, and the cash equivalents had earned the return on Treasury Bills. The Common Fund return was similarly calculated by applying to each college's actual asset allocations each year the investment results of The Common Fund's Equity, Bond, and Short Term investment funds.

While the 1.8 percent difference in the five-year annualized return between the 15.6 percent earned by Group A institutions and the 13.8 percent earned by Group B institutions might not appear to be dramatic, the study team notes that during the five years of the study the aggregate value of the endowments in Group B would have grown by an additional $81 million had the return been at the Group A higher rate.

For comparative purposes the study team notes that the performance of the securities markets varied considerably year-by-year during the five years covered by the study. Some representative indicators are in Table III.

TABLE II (Continued)

5-Year Annualized Market Index Rate of Return	Excess of Index Return × 5-Year Average Value	5-Year Annualized Common Fund Rate of Return	Excess of Common Fund Return × 5-Year Average Value
15.1%	$1,329	18.8%	$27,912
16.1%	—	18.7%	10,607
15.4%	—	18.2%	13,942
17.3%	32,084	19.6%	49,043
15.5%	20,685	16.9%	30,031
14.0%	—	17.2%	544
12.5%	—	15.0%	6,585
14.6%	—	17.9%	13,048
16.7%	—	21.2%	10,766
15.8%	4,038	19.6%	19,409
15.1%	—	18.4%	1,772
14.9%	7,777	18.6%	21,284
14.8%	6,689	17.5%	15,347
15.9%	798	19.4%	10,846
12.5%	—	15.9%	7,574
13.9%	3,491	17.3%	11,210
14.9%	—	20.6%	4,553
13.9%	258	16.0%	3,093
16.3%	511	19.2%	4,469
15.7%	1,281	19.3%	5,883
13.3%	450	16.0%	3,684
13.7%	—	16.8%	850
16.0%	81	20.2%	1,318

TABLE III

Movement of Securities Markets

Fiscal Years Ending June 30, 1979 to June 30, 1983

Item	1979	1980	1981	1982	1983	5-Year Annualized Rate
Standard & Poor's 500 Stock Index	+ 13.6%	+ 17.3%	+ 20.6%	− 11.5%	+ 61.1%	+ 18.1%
Salomon Brothers Bond Index	+ 7.2%	− 2.4%	− 13.0%	+ 8.7%	+ 42.4%	+ 7.1%
Rate on 91-Day Treasury Bills	+ 9.3%	+ 12.2%	+ 14.4%	+ 14.4%	+ 9.1%	+ 11.9%

Another way of viewing the importance of incremental return is to view it in a context of a widely accepted general statement concerning the maximum spending rate a college or university could use without invading the principal of the endowment. The statement is:

> The maximum spending rate should not exceed the expected long term annualized total rate of return minus the expected long term inflation rate.

This formula emphasizes the importance of the 1.8 percent difference cited above in the weighted annualized rate of return for Group A and B institutions. During the five-year period covered by the study, the annualized rate of inflation as measured by the Consumer Price Index was 8.8 percent. Subtracting inflation from the 15.6 percent earned by Group A institutions would provide a maximum spending level of 6.8 percent (not necessarily the recommended spending rate). Deducting inflation from the 13.8 percent return earned by Group B institutions would provide only a 5 percent maximum spending rate.

Performance could have been improved by both Group A and B institutions.

Although over the five years studied the performance of Group A institutions in endowment management was substantially better than that of institutions in Group B, room for improvement existed in both groups. The study team found this by employing an index that reflected the actual endowment asset allocation decisions of the institutions for each of the years; then it used the results of the Standard & Poor's 500 Stock Index and the Salomon Brothers Bond Index for comparison with actual results.

Only six of the twelve institutions in Group A outperformed this index over the five-year period, as shown in the top part of Chart 1, although three others came reasonably close to the index. However, not all Group A institutions had their restructured program in effect for the full five years. Those institutions that completed a management review and restructuring part of the way through the study period showed markedly improved performance after the restructuring was completed.

Only four of the eleven institutions in Group B outperformed this index over the period, as shown in the bottom part of Chart 1.

If over the period the Group A institutions had performed as well as the Standard & Poor's 500 Stock Index and the Salomon Brothers Bond Index, they would have had an additional $20 million in endowment resources.

If Group B institutions had performed as well as these indexes, the institutions would have added almost $59 million to their endowments.

Inasmuch as the foregoing analysis was adjusted for asset allocation decisions, the data reflect the results of management and exclude changes due to fluctuations in the stock and bond markets.

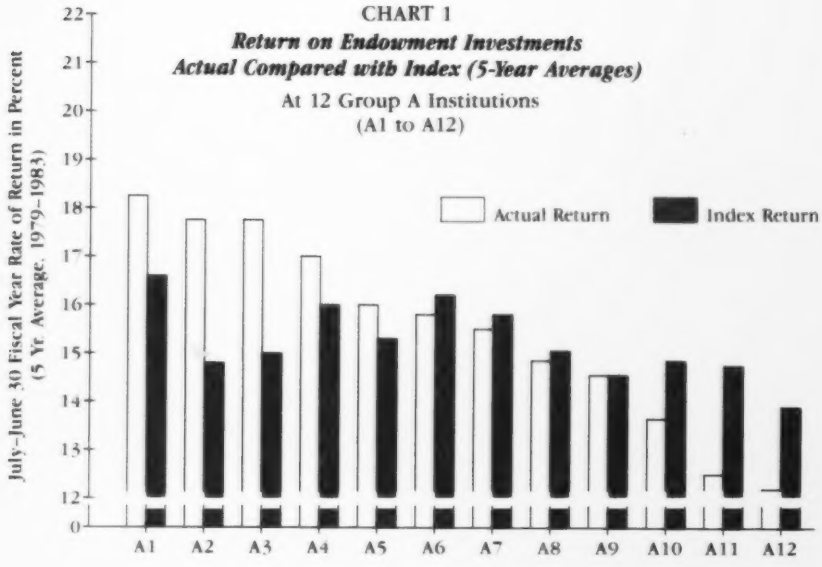
The study team noted that the index return comparisons are approximations because the calculations were based on endowment values at the beginning of the year without regard to cash flows that occurred during the year.*

*A similar method was followed in making the calculations for The Common Fund as described in the next section.

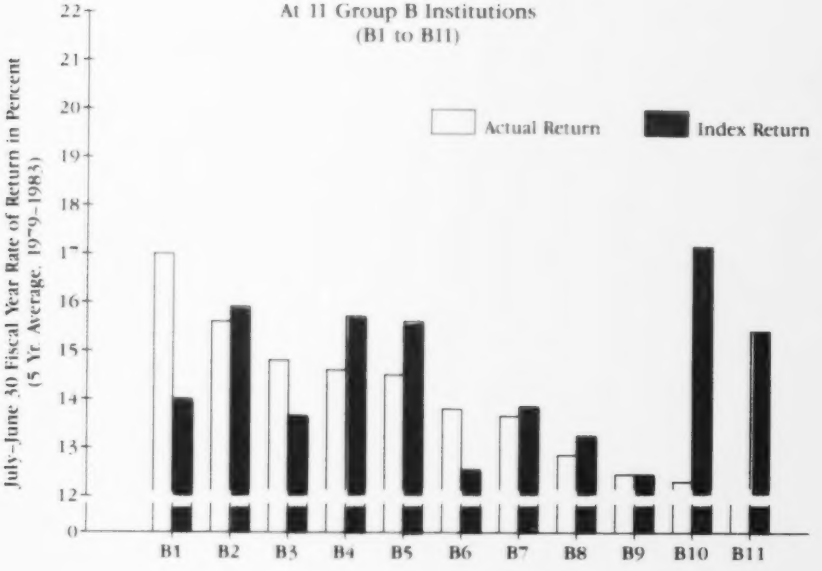
CHART 1

Return on Endowment Investments
Actual Compared with Index (5-Year Averages)

At 12 Group A Institutions
(A1 to A12)



At 11 Group B Institutions
(B1 to B11)



Source: AED Study of Endowment Funds

Note: The index return was calculated by assuming that for each year of the study the amount allocated by each institution to stocks earned that year's rate of return on the S&P 500 stock index, that the amount invested in bonds earned the return on the Salomon Brothers Bond Index, and that cash earned the average rate on 3-month Treasury Bills.

A few institutions did not have at hand data on actual performance in the fiscal year 1979. The charts and tables in the report assumed that for that year the institutions involved earned returns equal to the market index returns. The study did not attempt to adjust returns on investment for the different levels of risk assumed by each individual institution in its allocation of endowment assets to stocks, bonds, and cash-equivalent investments.

Common Fund demonstrates potential for improvement.

As a point of reference and as an example only, the study team noted the structure and investment performance of The Common Fund, a nonprofit corporation organized to provide investment management services exclusively for education institutions. The Common Fund is a pooled endowment fund supervised by a board of trustees responsible only for investment matters. The focus is on investments, with separate subcommittees established to manage equities, bonds, short-term securities, and international investments.

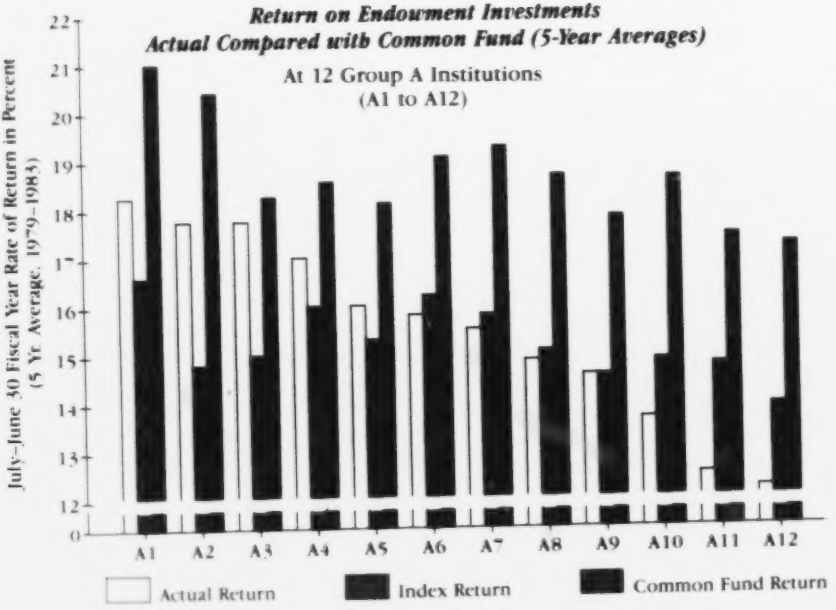
Since its inception in 1971 The Common Fund has taken the view that the proper role of trustees is to manage managers, not investments, and has employed a multiple manager approach to investing. Over the years, The Common Fund's trustees have utilized the services of several leading investment consulting firms and have chosen separate managers with special expertise and proven records of accomplishment in each separate aspect of investment, such as equities, bonds, short-term, and international.

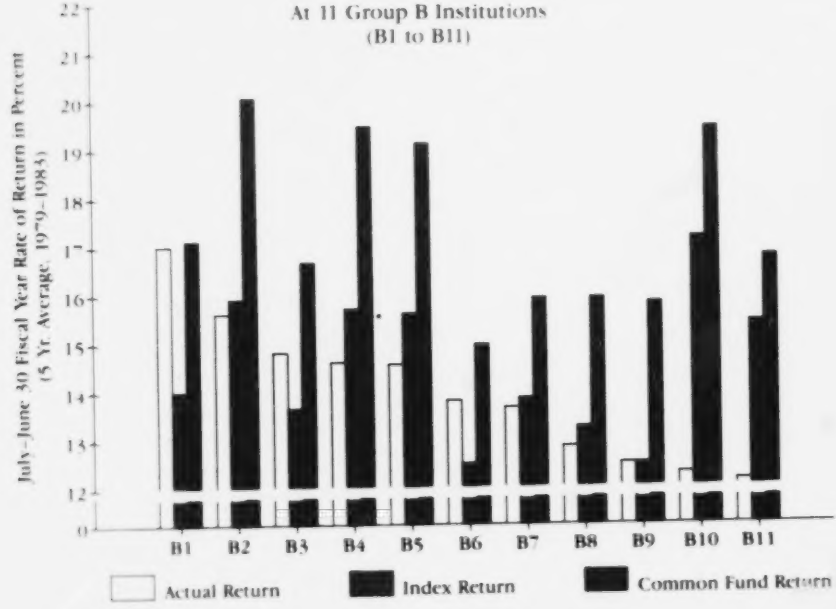
The Common Funds' board of trustees, elected by participants distributed across the country, includes the treasurers of several major university endowments and a number of other persons chosen for their financial expertise or as representatives of national education organizations. The board takes great care to avoid conflicts of interest in choosing investment managers and custodial banks.

The potential for improvement that could have occurred over the five years had The Common Fund been used is highlighted by a comparison of the actual rates of return at the institutions in Groups A and B with the returns that would have resulted from participation in The Common Fund. The comparison shows that after adjusting the figures for asset allocation decisions, none of the institutions in Group A or Group B performed as well as The Common Fund. Had the Group A institutions maintained the same asset allocation and had they used The Common Fund, they would have augmented their total endowment funds in 1983 by more than $145 million; Group B institutions would have added an additional $128 million to their 1983 total endowment funds. Comparative data are shown in Chart 2.

CHART 2

Return on Endowment Investments
Actual Compared with Common Fund (5-Year Averages)





Source: AED Study of Endowment Funds
Note: Common Fund returns were calculated by assuming that for each year of the study the amount allocated by each institution to stocks, bonds, and cash earned that year's rate of return on The Common Fund's Equity, Bond, and Short Term investment pools

The study team noted that the investment results for The Common Fund's equity investments during the five-year period covered by the study enjoyed a wider margin of superiority over the market than has typically been the case. The five-year annualized return on The Common Fund's equity investments during the period was 22.8 percent per year compared with 18.1 percent for the Standard & Poor's 500 stock index. The Common Fund outperformed the index in each of the five years encompassed by the study. Over the longer term, The Common Fund has outperformed the market about 70 percent of the time. The annualized return for the past ten years, for example, has been 17.1 percent compared with 14.8 percent for securities in the S&P 500 index.

Nevertheless, the highly structured and focused approach to endowment management taken by the trustees of The Common Fund provides an example that could be followed by many colleges and universities. The results achieved illustrate the basic conclusion of this report; that is, the way a board of trustees approaches investment management can be expected to have a substantial impact on the long-term results achieved.

Strategic allocation of assets can increase endowment earnings.

Over the years, investments in common stocks have produced higher returns than investments in either bonds or money market securities. In order to reduce the effect on the value of the endowment of stock price fluctuations, many institutions have adopted for the endowment portfolio a strategy that diversifies investments into a number of different kinds of stocks (for example, some growth issues, some cyclical, some high yield, etc.) and by combining stocks with both bond and money market investments.

In both 1979 and 1983 the Group A colleges and universities using consulting assistance in establishing asset allocation guidelines and employing multiple investment managers with diverse strategies held a significantly higher proportion of stocks than the Group B institutions. A comparison is in Table IV.

TABLE IV

Allocation of Endowment Portfolios
by Two Groups of Institutions
by Type of Investment
1979 and 1983

Year and Type of Investment	Group A Institutions	Group B Institutions
1979		
Stocks	61.9%	42.7%
Bonds	31.3%	36.2%
Cash or Equivalent	6.8%	21.1%
Total	**100.0%**	**100.0%**
1983		
Stocks	68.0%	56.0%
Bonds	26.7%	34.0%
Cash or Equivalent	5.3%	10.0%
Total	**100.0%**	**100.0%**

Many institutions do not view asset allocation decisions as a key trustee responsibility despite the evidence that their decisions may mean at least as much as the quality of the managers in determining the overall results. The evidence supporting this conclusion is supported by the fact that 13 of the 21 institutions report examining asset allocation issues no more than once a year or even less frequently.

During the period involved, the Group A institutions allocated their assets in order to take advantage of the upward swings in the stock market to a greater degree than did Group B institutions. Had the Group B institutions allocated their investments in stocks, bonds, and cash in the same proportions as the institutions in Group A, they would have increased their annualized rate of return during the five-year period by 1.5 percent per year. The five-year cumulative impact of this increased return on the total endowments of the Group B institutions would have added $50 million to the total endowment value.

The study team noted that Group B institutions increased the percentage invested in stocks over the five years by reducing their cash or equivalent holdings; the percentage in bonds remained virtually constant. Group A institutions reduced both the percentage of investments held in bonds and in cash or equivalents in order to increase the commitment to stocks.

"Market reaction" asset shifts tend to be counterproductive.

Some institutions tend to react to negative market developments and, as a result, change their asset allocations in a counterproductive way. For example during the first half of 1981 after four years of declining bond prices, one of the Group A institutions with a relatively large endowment and with a relatively good annualized rate of return reduced its bond allocation from 30 percent to 5 percent. In September 1981, however, the bond market began what turned out to be the most dramatic rally in 50 years.

In early 1982 one of the Group B institutions, attempting to increase its endowment income, chose to reduce the endowment fund allocation in stocks from 42 percent to 28 percent. Shortly thereafter, in August 1982, the greatest 12-month rally in stock prices in the last five decades began.

In mid-1981, just before the bond market rally, Group A institutions in the aggregate had their lowest allocation in bonds. Conversely, in mid-1982, just before the major stock market rally, the lowest percentage allocation was in stocks.

The study team observed that the tendency to allocate assets in a way that had an adverse impact on performance has also been common among corporate pension funds. This tendency argues for new approaches to asset allocation among large investment funds—approaches that focus on relative value and long-term return expectations, rather than on a concentration on recent market performance.

Three trends that have led to a better endowment fund performance.

The study team found three important trends among the Group A and B institutions which have led to better endowment fund performance. First, increasingly trustees have seen their role to be "managing the professional managers" rather than "managing the funds themselves." Second, institutions

have chosen multiple investment managers in order to gain greater diversification, more specialization, added value, and reduced volatility. For example, all of the institutions in Group A used more than one manager, with two using as many as eight managers. In contrast, seven of the Group B institutions each used only a single manager. Third, institutions have selected investment managers on the basis of specialized skills and performance results rather than on geographic location.

Increasingly, portions of endowment portfolios are being invested in alternative kinds of assets.

In recent years managers of college and university endowment funds have begun to invest in alternative kinds of assets (such as real estate, options, venture capital, and international activities) as a part in the overall investment strategy.

The study team noted that during the five-year period studied, 11 of the 12 Group A institutions and 4 of the 11 Group B institutions invested in alternative assets during all or part of the period covered by the study.

The use of independent investment consultants is increasing.

The study team found that colleges and universities are turning to independent consultants to assist in evaluating endowment management structure, practices, and performance; to help in evaluating managers and in selecting new managers when required; and to provide objectivity when sensitivities are involved.

Study participants who had used independent consultants to assist in managing endowments stressed the value of the service provided. They suggested also that outside consultants were the *single* most important reason for improved performance of endowment funds and for increased understanding among trustees of the problems involved in endowment management. As mentioned earlier, all of the institutions in Group A had used independent consultants as part of the overall review of their endowment management practices. During the course of the study, three Group B institutions initiated formal reviews of the structure and performance of their endowment funds. Additionally, on July 1, 1983, one Group B institution made a substantial change in the structure, asset allocation, and management of its endowment fund.

Custodian services provided by banks were found wanting.

Most of the institutions studied felt the relationship with banks providing custodian services could be improved substantially. Although many institutions were dissatisifed, few were explicit with respect to what they would like. The greatest general complaint was that banks provided "warmed over" trust accounting and custodial packages and were slow to credit income and reinvest interest. Only a few said that their banks were providing effective service.

The main specific complaints were that some institutions were unable to verify the fact that their funds were fully invested on a daily basis and assure themselves that the custodian bank was providing adequate, accurate, and timely information.

During the period of study, some major changes did take place in the provision of custodian services including improvements in cash management (investing, collecting, and forecasting), securities settlements (sales and purchases), and investment accounting and reporting. The study team noted that while many custodian banks have upgraded their services, a considerable difference exists in the types of services offered and the prices charged by various banks.

Development offices need to better understand endowment investment policies.

Administrators in all of the Group A institutions and in five of the Group B institutions felt that their development office staff needed to be better informed about the endowment management practices, the institution's spending policy, and the rationale for that policy. They noted that before making a gift, donors want to know how well an institution is managing its endowment resources. Donors frequently have a preconceived expectation as to the effect their endowment contribution will have on the annual operating budget. Their expectation usually is higher than a prudent spending plan allows for. A similar higher expectation exists also among academic departments and faculty. The nature and characteristics of a gift can be influenced significantly during discussions between a prospective donor and the institution. Required, therefore, is a broad institutional understanding of a potential donor's priorities and objectives.

The institutions with better performance records are more disciplined in their spending plans.

The study team found that at those institutions that have developed a structured approach to endowment management including heavy trustee involvement, spending out of endowment earnings increasingly has been limited to a reasonable percentage of the three or five-year moving average market value of the endowment fund.

For example, at ten of the twelve Group A institutions the policy has been to spend 6.5 percent or less of the three-year moving average value of the endowment fund. On the other hand, at four of the eleven Group B institutions, the policy has been to spend all of the income generated each year. At four other Group B institutions, spending has been at a level well above endowment fund performance when adjusted for the impact of inflation over the period.

A sample statement for colleges and universities regarding investment policy, objectives, and guidelines for endowment funds is in Appendix B. A sample spending policy guideline statement and a spending plan illustration is in Appendix C.

Factors other than performance still influence the selection of managers of endowment funds.

The study team felt there was no doubt that some decisions on appointing managers of an endowment fund are made on the basis of criteria other than carefully analyzed performance figures. Several organizations were used to manage endowment funds despite marginal or poor performance. A

management firm or bank with which a trustee was associated was used because the institution was not "charged" for the service, or was charged at a lower than the customary rate. A firm with which an alumnus or a major donor was associated was used without regard to performance.

The study team felt that when trustees are seriously concerned about the need to maintain good relations with a local bank, the custodian function and the management function for the endowment should be divided to make it possible to improve the fund's performance.

Final note.

The study team observed that trustees and administrators are not making full use of the many analytical tools and services available in the financial markets to help review and analyze endowment management performance and to improve practices.

The team observed also that some confusion exists about who is responsible for endowment management, what questions a trustee may legitimately ask, what role the administration plays in endowment management, and what kind of analytical comparisons will be most helpful in assessing endowment performance. The study team feels that all colleges and universities should establish clearly the relationship between the trustee committees concerned with endowment management and those concerned with the operating budget and overall planning.

Appendix A

Checklist of Questions About Endowment Management for College and University Trustees

Organization for Endowment Management

1. Is the responsibility for directing and supervising endowment management practices assigned to an investment committee of the board of trustees?

   Investment supervision carried by a finance or executive committee instead of an investment committee might not get sufficient attention because of the urgent demand for time to be spent on budget and other pressing financial matters.

2. Does the investment committee include individuals with professional experience in investment management or in overseeing investment management?

   Investment management is a specialized activity requiring enough expertise to assure the board of trustees that selection of investment managers and evaluation of their work is done properly.

3. Is the endowment investment or overseeing function staffed as a separate responsibility within the office of the chief financial officer, or as a separate responsibility reporting to the board of trustees?

   The appointment of a separate investment officer is not the normal practice unless the endowment is quite large, say, in excess of $100 million.

4. What relevant experience does the individual with staff responsibility for endowment management (whether full-time or part-time) have?

5. Is the investment of the endowment assets managed internally or externally?

   The experience is that it is not good practice generally to have endowment investments managed by a trustee committee, or by assigning investment management as a part-time responsibility of the treasurer or financial vice president. Some large endowments are managed by a full-time professional staff, under the supervision of a trustee investment committee.

6. Does the institution have a single endowment fund or several funds with different objectives?

   Funds with different objectives may appropriately have different proportions of stocks, bonds, cash, etc.

7. Do separate units of the institution (such as colleges or divisions) have separate endowment funds?

If so, a clear understanding with the deans in charge of the subunits is important in order to avoid the possibility of spending requirements dictating investment policy.

8. Is there a separate function with an endowment fund?

Many publicly supported institutions hold endowment funds in separately incorporated foundations with a separate, sometimes overlapping, board of trustees.

9. Does the institution have a conflict of interest statement for trustees? For members of the administration? Does anyone (if so, who?) conduct a survey periodically to review the conflict of interest situation? Has the situation been reviewed recently by legal counsel?

Sample conflict of interest questionnaires and guidelines for their use are available from The Common Fund.

10. What are the institution's policies with respect to voting the stock held by endowment funds?

The usual practice is for the investment manager to vote stock proxies. However, when social responsibility issues arise, the institution's board of trustees often takes over the responsibility for voting the stock.

11. Does the institution have a policy statement on the manner in which social responsibility issues are to be treated?

The statement may prohibit investments in certain types of businesses, or may include policy and procedures for voting on social responsibility issues.

Endowment Management Policy

1. Who at the institution is involved in developing and approving the policy statement on endowment management? The administration? The board committee(s)? The full board?

Good practice is for the trustee investment committee to develop the policy statement with assistance from staff and/or an independent consultant. Then the statement should be reviewed and adopted by the full board.

2. Are the institutional and financial premises on which the policy statement is based stated explicitly and reviewed periodically?

3. Do all board members have a copy of the policy statement on endowment management?

4. How long has the current endowment management policy statement been in effect?

Periodic review is needed at each institution, obviously, to stay abreast of changing financial circumstances.

5. What changes in conditions, if any, would lead to changes in investment goals?

The Plan for Spending Endowment Income

1. What is the current endowment spending plan in terms of dollars? In percentage of market value?

> A paper on spending policy for endowment funds, available from The Common Fund, concludes that generally a reasonable spending rate is 5 to 5.5 percent of a multi-year moving average market value. If a greater spending rate occurs, it should be reviewed by an institution's trustees.

2. How is the return of the endowment calculated for the purposes of implementing the spending plan?

> The appropriate method is to calculate total return at least quarterly, based on accrued income, plus or minus the change in market value. NACUBO has published a handbook on unit value accounting and calculating rates of return.

3. On what premises is the spending plan based?

> What is the assumed or targeted total return? What is the assumed rate of inflation?

4. Does the spending plan use different criteria for the distribution of income from quasi-endowment funds as compared to income from pure endowment funds? Do the criteria differ for restricted and unrestricted endowment?

> The spending rate for scholarship funds might, for example, be higher than the rate for unrestricted endowment. This may affect allocation policy.

5. Is the endowment spending plan developed as part of the annual budget process or is it independent of that process?

> Using endowment income to try to balance the budget can easily lead to an excessive spending rate. The board should first determine what is a reasonable spending rate.

6. What percentage of the current educational and general budget comes from income on the endowment? What has been the five-year trend in this percentage?

> For the 23 institutions in this study, the average contribution to budget was in the range of 5 percent, but varied from as little as 2 percent to as much as 20 percent.

Asset Allocation

1. Who is responsible for recommending and establishing asset allocation guidelines?

> The ultimate responsibility belongs to the institution's board of trustees. This is not to suggest that professional advice or assistance should not be sought. However, asset allocation should not be left to an investment manager without clear guidelines from trustees.

2. What are the current asset allocation guidelines? How recently were these guidelines reviewed?

3. What is the range (normal, high, and low) in percentages for the investment of the asset in the endowment?

- Stocks
- Bonds
- Foreign securities
- Options
- Futures
- Venture capital funds
- Real estate
- Cash equivalents

The 1983 NACUBO Endowment Survey indicated: stocks, 58 percent; bonds, 29 percent; cash equivalents, 9 percent; real estate, 2 percent; venture capital, options and futures, and others, 2 percent.

4. What criteria are used in deciding on the range of alternative endowment investments?

5. After a review of performance of the various types of endowment investments, how are asset allocations rebalanced?

After guidelines have been established, there should be a periodic rebalancing with at least an annual review. Major changes (over 10 percent) in the price level of either bonds or stocks should also trigger a review.

6. Has outside counsel been used in examining asset allocation alternatives?

Independent consultants often can be helpful in providing perspective for the trustees by supplying factual data on capital market returns.

Investment Guidelines for Endowment Funds

1. Are investment guidelines specific regarding particular holdings or percentages in certain types of holdings?

Appendix B of this report provides suggestions on how specific the guidelines might be.

2. How are the managers of endowment funds informed about the guidelines or changes in the guidelines?

Written guidelines should be given to the manager and reviewed briefly at each investment management review meeting.

3. Does the board or any board committee ever become involved in selecting or rejecting specific holdings? If so, on what basis?

Normally, according to several studies, this is not good practice. However, trustee involvement may be appropriate when a specific issue arises, as, for example, social responsibility.

Selecting Investment Managers

1. How are managers selected? Are outside advisers used?

The experience of the institutions in this study suggests that the use of an independent consultant can be helpful.

2. What kind of information about potential managers is obtained for review during the selection process?

If an institution does not use a consultant, advice and specific criteria can be obtained from The Common Fund.

3. Do local area investment managers receive preference?

The experience reported during this and other studies suggests local managers should be subject to the same criteria and performance standards as other managers.

4. Are multiple managers used? If so, how are the funds allocated to the different managers? How do their guidelines vary?

Multiple management can enhance the return of the endowment, and provide improved specialization, diversification, and added value.

5. Will new funds be allocated to the managers in the same proportion as they are now?

A good idea generally is to allocate cash flows proportionally to managers or directly to the worst performing manager. It is dangerous to add funds to the manager who has had an exceptionally good recent performance.

6. How often does each investment manager make a presentation to the board of trustees or the investment committee of the board?

Review sessions should be held at least twice a year, usually not more often than quarterly.

7. Do any of the investment managers have "special" relationships with the institution?

Conflicts of interest usually do not provide any net real long-term benefit for the institution.

8. How is the performance of an investment manager evaluated?

Good practice is to obtain performance data and comparative benchmarks at least quarterly, and to evaluate performance over a three-year to five-year period.

9. Under what conditions would the institution change investment managers?

If a manager underperforms the appropriate market benchmarks for a period of several years, the institution is ready for a change.

Evaluating Endowment Performance

1. How is the return on each portion of the endowment calculated?

Separate data on the rate of return on stocks and bonds, as well as on other major classes of assets, are more useful in evaluating managers' skills than are composite figures on fund performance.

2. How is endowment performance evaluated? How often? By whom? Using what criteria?

Here, also, independent consultants can be helpful. Although a reasonably long time period, usually three to five years, is desirable for evaluating performance, regular performance reports should be compiled at least quarterly.

3. What external indices of market performance are used for comparison purposes? The Dow Jones Indices, Standard & Poor's 500 Stocks, Salomon Brothers Bond Index? The Common Fund? Shearson/Lehman Corporate and Government Composite Bond Index?

Custodial Services

1. Is a custodian bank used? How was that bank selected?

> The quality and timeliness of reporting, the ability to process security transactions and to collect dividends and interest — all at a reasonable cost — are the appropriate criteria. Geographic proximity should not be the dominant factor. Some areas to be explored are: volume of custodial business, cash management, fails on security transactions, short term investment of funds, accounting and reporting, central depository, computing equipment systems, and audit/control.

2. How long has the custodian relationship existed? Is the institution satisfied with the current reports, the full investment, and the overall custodial performance?

3. How are custodian fees determined?

> While traditionally fees have been based on a percentage of assets, a more appropriate fee structure would be one based on number of managers (accounts), transactions, and the frequency of activity.

4. What kinds of reports are prepared? How often? Who reviews the information? What kinds of questions are raised?

> A reasonable standard would be quarterly valuations and distributions of income. Auditors should review the reports at least annually.

Building the Endowment

1. In the past what were the major sources of the funds that built the endowment? Can these same sources be expected to be the key to endowment growth in the future?

2. What percentage of the unrestricted annual voluntary support for the institution is invested in the endowment as compared to the percentage used for current operating expenses? How has this changed over the last five years?

> Annual giving is usually earmarked for the current operating budget. However, larger gifts should be targeted for longer term involvement.

3. Over the last five years has the amount of endowment per student, in real dollars, decreased, stayed constant, or increased?

4. Over the last five years has the amount of endowment per faculty member, in real dollars, decreased, stayed constant, or increased?

5. Over the last five years how has the market value of the endowment changed in relationship to the institution's operating budget? Remained constant? Declined? By what percent? Increased? By what percent?

> The experience of most endowments indicates that if endowment growth keeps pace with the rate of inflation, the institution is doing reasonably well. Between the fiscal year 1979 and the fiscal year 1983, the average endowment growth shown by the NACUBO survey was 8 percent. Inflation was 8.8 percent.

Appendix B

Sample Statement for Colleges and Universities Regarding Investment Policy, Objectives, and Guidelines for Endowment Funds

NOTE: This sample statement is intended simply as a framework for addressing in an orderly way the issues involved in endowment management. The statement should not be viewed as an ideal or recommended policy for all institutions.

Philosophy

The responsibility of the trustees is to establish broad guidelines for the endowment, select investment managers, and determine or approve asset allocation. The investment managers are responsible for optimizing the return on the assets within the guidelines that have been established. Unless specifically desired or approved, extreme positions or variations in an individual manager's style are not consistent with these objectives.

The endowment fund is a permanent fund with disciplined investment objectives and consistent management strategies that can accommodate any relevant, reasonable, or probable events.

The careful management of endowment assets is designed to ensure a total return (yield plus capital appreciation) necessary at least to preserve and, it is hoped, enhance (in real dollar terms) the principal of the endowment fund, and at the same time provide a dependable source of income for current operations.

The purpose of equity investments is to provide current income, growth of income, and appreciation of principal. The purpose of fixed income investments is to provide a predictable and dependable source of income and to reduce portfolio volatility. The fixed income and equity portions of the investment portfolio are to be diversified in order to provide reasonable assurance that investment in either a single security or a class of securities can not have an excessive impact on the total portfolio.

Other than indicated in this statement, investment managers are to have complete investment discretion with the expectation that funds will be invested with care, skill, prudence, and diligence.

General Investment Objectives and Guidelines

The return objective is to earn an average annual total real rate of return (adjusted for inflation) of five to six percent, as measured over a three-year to five-year market period, and at the same time to outperform selected weighted market indices.

The asset mix of the endowment fund is to range approximately within the following limits:

Fixed income securities*	20% to 35%
Common stocks (including convertibles)*	65% to 80%

Equity Investment

Investments in a particular industry or company are to be based upon a demonstrable analysis of prospects for above-average return over a three-year to five-year period. Emphasis is to be placed on capital appreciation and growth of earnings.

Investments are to be made primarily in well established, quality companies whose securities enjoy marketability adequate for the portfolio. Quality is not synonymous with size or recognition. For example, equity investments in high-quality, well-established, smaller companies (capitalized, for instance, at between $50 million and $250 million) can be superior vehicles for preservation and enhancement of capital.

At the time of investment no manager is to invest more than five percent of the net assets of the fund in securities of organizations with less than a three-year operating record. A manager is to concentrate no more than 20 percent of the market value of the fund in any single industry and no more than five percent in any single company without prior approval of the Investment Committee or its designee(s) at the time of investment.

Investments in equity (or debt issues) of smaller or small emerging companies may be made within the overall guidelines expressed in this statement. These investments (as distinguished from gifts made to the institution) may not be made in letter stock or unregistered or privately placed securities without prior approval of the Investment Committee or its designee(s).

The use of options, futures, and other hedging strategies is permissible subject to prior review and approval by the Investment Committee.

Real estate investments may be made up to 15 percent of the aggregrate portfolio market value, with emphasis placed on investments producing high current return combined with residual equity values. Individual investments or investment program strategies are subject to prior approval of the Investment Committee or its designee(s).

Investments in foreign securities are appropriate as a form of diversification and may be made up to 10 percent of the aggregate portfolio market value.

Venture capital investments may be made up to 10 percent of the aggregate portfolio market value, with individual investments or investment program strategies subject to prior approval of the Investment Committee or its designee(s).

Fixed Income Securities

The structure of the bond portfolio and the selection of individual securities are matters of investment management discretion, developed primarily in response to changing market relationships, interest rate forecasts,

*Includes cash and cash equivalents.

and economic circumstances.

The portfolio is to be comprised of high quality issues carrying Moody's ratings of A and above or the equivalent unless approved by the Investment Committee or its designee(s).

Call protection is to be emphasized to assure stable and current income.

General

Lending securities (Securities Lending Program) is permissible as part of the investment program, subject to presentation to the Investment Committee before implementation.

As a general guideline that applies to all assets managed, transactions are to be entered into on the basis of "best execution," which normally means best realized price. Commissions may be paid for investment services rendered to the institution upon the approval of the Investment Committee's designee(s).

Investor Responsibility

The board recognizes its role as a "responsible" investor. While the primary purpose of managing the endowment is to maximize return on the assets within an appropriate level of risk, companies in the portfolio that might cause concern to the institution are to be reviewed regularly by the Committee on Investor Responsibility. In exercising its responsibility, the Committee may:

- Vote properly drafted proxies, or instruct the manager to vote proxies that relate to social responsibility issues,
- Communicate directly with management,
- Recommend other actions to the board.

The Committee on Investor Responsibility is to report regularly to the board.

Investment Managers

The Investment Committee allocates funds to individual managers and from time to time may withdraw funds from or reallocate funds between managers. Each manager's performance is to be compared regularly with the performance of equity and fixed income market indices, with mutual funds having similar objectives, with other funds managed by "peer group" managers (for example, with similar styles and objectives), and with other endowment funds.

Over a three to five-year period equity managers are to be expected to achieve an average total rate of return that exceeds the Standard & Poor's 500 rate of return by 1½ to 2 percent compounded annually, net of fees. Fixed income managers are to be expected to achieve an average total rate of return 1 to 1½ percent compounded annually higher than the rate of return on the Shearson/Lehman Corporate and Government Composite Index.

Custodial responsibility for all securities is to be determined by the Investment Committee or its designee(s).

Investment managers are responsible for frequent and open communication with the college or university on all significant matters pertaining to the assets managed. Objective evaluations of investment managers are to be made periodically.

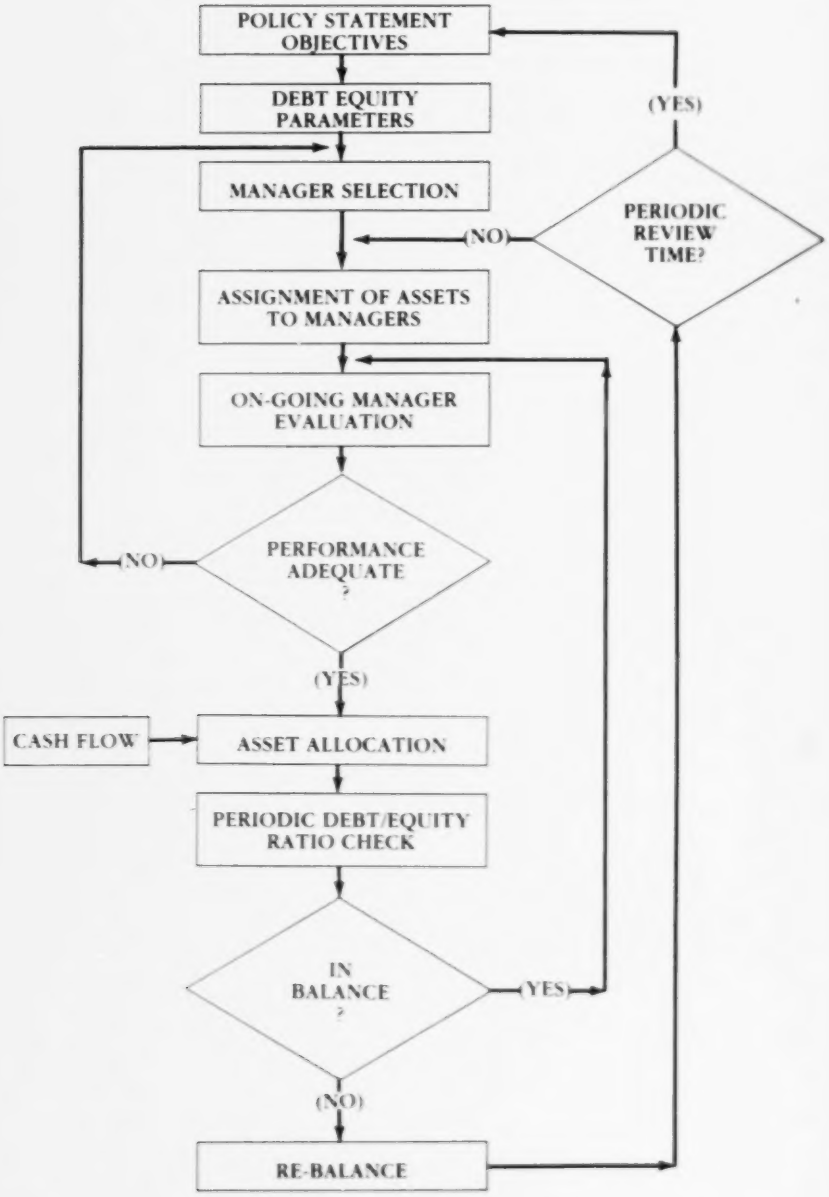
The Investment Committee is to meet as often as necessary with the investment managers. The frequency of meetings is to be determined in part by the performance evaluation results compared to predetermined objectives and manager characteristics. The committee is to meet with each manager at least once a year.

Investment Management Responsibility

Chart 3 provides an example of program discipline related to policy review, debt/equity parameters, asset allocation, and performance measurement. The diagram shows the comprehensive investment management responsibility process of an Investment Committee of the Board of Trustees of a college or university.

CHART 3

Diagram Showing the Comprehensive Investment Management Responsibility Process of An Investment Committee



Appendix C

Sample Spending Policy Guideline Statement and Spending Plan Illustration

NOTE: It should be emphasized that spending policies and practices vary widely among educational institutions. These sample policy guidelines are simply intended as a framework for addressing the issues involved in an orderly and comprehensive way. They should not be viewed as an ideal or recommended policy for all institutions. NACUBO's Investment Committee has an ongoing interest in this topic and is working toward developing other models. The reader is encouraged to contact NACUBO for further information on this subject.

Introduction

The objectives of the Investment Committee are: (a) to ensure a total return necessary to at least preserve and, it is hoped, enhance in real dollar terms the principal of the endowment fund; (b) to provide a dependable source of funds for current operations; and (c) to provide for financial equilibrium (increasing funds available for current purposes at a rate equal to other major institutional revenue sources).

These objectives provide both a comprehensive concept of financial responsibility and a delicate sensitivity to preserving educational quality by appropriately balancing present institution resource needs with those of the future.

Endowment spending policy reflects the blending of these objectives and the balancing of the present and the future. The policy is based on an understanding and development of defined needs of an institution and reflects appropriate financial responsibility in the best interest of the institution.

The sample spending policy guideline includes several important concepts. It relates endowment income spending to the long term investment return objectives of maximizing total return on the endowment. It also utilizes market value considerations only for the purpose of determing prudent spending limits. The guideline ensures, to the degree possible, that the amount taken from the endowment will increase in a modest and controlled way each year. Finally, it relates spending to total return and to inflation as expressed by the following formula:

> Endowment Spending is equal to or less than Total Return minus Inflation
> or expressed another way
>
> Total Return (TROR) is equal to or greater than Endowment Spending plus Inflation.

Spending and Spending Limitations

The amount of endowment return available for current spending (distribution) during a fiscal year is to be determined on the basis of the number of units (or shares) as of the preceding December 31. The distribution per unit of the current year will be increased by the average projected percentage increase in the institutional budget (inflation index) for the succeeding year.

However, the anticipated distribution per unit is not to exceed 5.5 percent of the average market value per unit for the last 12 quarters unless reviewed and approved by both the Investment and Finance Committees.

On the other hand, if the proposed distribution per unit falls below 4.5 percent of the average market value for the latest 12 quarters, the Investment and the Finance Committees also should review the situation and agree on a decision.

Additional Allowances

Additional distributions may be made for new shares during the fiscal year. New funds purchasing units prior to the mid-point of the fiscal year will be entitled to receive one-half the annual distribution per unit. Funds purchasing units after the mid-point of the fiscal year will not be entitled to receive a distribution during the current fiscal year.

Example

The example presented below shows how these guidelines operate using the actual total annual rate of return compounded for Group A institutions in the study (that is, 15.6 percent). The inflation rate of 8.8 percent used in the example is the annual compounded inflation rate for the period covered by the study. Additional assumptions are:

- Initial endowment fund of $10 million.
- Initial spending amount is 5 percent of initial market value.
- Spending guideline of the previous year's amount plus inflation not to exceed 5.5 percent of the three-year (12-quarter) moving market value average.

Spending Plan Illustration

Year	Beginning of Year	TROR Amount ≧	Endowment Spending	+	Offset for Inflation	End of Year	Average 3-Year Market Value	Spending Limit
1	$10.0M	$1.56M	$500K		$880K	$11.06M	$10.0M	$550K
2	11.06M	1.73M	544K		970K	12.25M	10.35M	570K
3	12.25M	1.91M	592K		1.08M	13.57M	11.10M	610K
4	13.57M	2.12M	644K		1.19M	15.05M	12.29M	680K
5	$15.05M	$2.35M	$700K		$1.32M	$16.70M	$13.62M	$750K

≧ equal to or greater than
M millions of dollars
K thousands of dollars
TROR total return